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SUBJECT: SELL-OFF IN TURKISH MARKETS

REF: ANKARA 2324

1. (Sbu) Last week's Turkish market correction picked up steam this week with a strong sell-off in equity and currency markets and an uptick in Government securities' interest rates. Despite the Central Bank halting its foreign exchange purchase auctions, the TL hit 1.43 million to the USD Tuesday morning, the lowest level in 2004, before easing back to 1.420 at the close. Equity markets fell 1.99 percent Tuesday after falling 4.5 percent Monday. The interest rate on the benchmark Treasury bond increased 48 basis points Tuesday to 24.38 percent. Post contacts attribute the sell-off to a combination of foreign selling, increased expectations of a U.S. interest rate hike, market disappointment that the EU did not give stronger recognition to Turkey's efforts on Cyprus, and a herd-like behavior. End Summary.

Monday-Tuesday Sell-off:

2. (U) Last week's volatility and nervousness in Turkish financial markets continued into this week, with an accelerating sell-off that only stabilized Tuesday afternoon. On Monday, the equity markets were hardest hit with a fall of 4.35 percent in the IMKB 100 from last week's close to 18,586.45. On Tuesday morning the selling continued through the psychological 18,000 barrier in the morning, before coming back up to 18,217.13 at the close--a 1.99 percent fall for the day.

3. (Sbu) Foreign exchange markets have been more or less on a falling trend for the past couple of weeks since the Central Bank was widely considered to have spooked markets by overdoing its FX buying auctions in mid-April. With last week's lira weakness, many analysts were expecting the Central Bank to cut back its auctions--and possibly cut interest rates--once the Cyprus referendum was over. The lira depreciation accelerated in late afternoon trading Monday (the lira closed at 1.391 million to the USD yesterday, down from 1.382 on the day), and depreciated sharply early Tuesday, breaking through the TL 1.4 million barrier. The Central Bank promptly announced it would cease its FX buying auctions until May 3. Interestingly, the announcement caused the lira to appreciate back below TL 1.4 million but then quickly resumed its fall, getting over TL 1.43, its lowest level in 2004, before coming back to TL 1.4205 at the close.

4. (U) Interest rates on government securities, which had been inching up since they hit early April lows of below 22 percent on the benchmark bond, had a notable uptick on Tuesday, rising 48 basis points to 23.46 percent on the benchmark. Despite the upward movement in interest rates, the Treasury's ability to tap the markets and roll over its debt remains undamaged: the Treasury successfully sold about 2.8 Quadrillion TL (\$2.0 billion) of t-bills and bonds on Tuesday, of which TL 2.0 Quadrillion were 535 day bonds that will help Treasury in its key goal of increasing the average maturity of its TL-denominated debt.

Motivating Factors:

5. (Sbu) Post contacts did not see a single driving factor in the sell-off, instead attributing it to a combination of factors. The increased expectation of a Fed hike in U.S. interest rates that played a key role in last week's

correction continued to be a factor. Baturalp Candemir of HC Istanbul said that several U.S.-based funds told him that a combination of increased U.S. rate hike expectations and a desire to lower their Turkey exposure caused them to pull funds out of Turkish assets, especially fixed income instruments. Candemir said that even though equities appear to have been hardest hit, the equity market is hyper-sensitive to small amounts of foreign selling whereas it takes much larger amounts to have a dramatic impact on fixed income markets. He said that ever since the Central Bank overdid its FX buying two weeks ago, foreigners pulled back from the game they had been playing, i.e. betting on a continued strong lira and steadily falling Turkish interest rates. Candemir estimates that of the roughly \$5.8 billion of foreign money invested in Turkish fixed income assets at the end of March, something like \$1.5 billion has pulled out in April.

16. (Sbu) Candemir attributes the fall in the lira to these foreign investors pulling out of fixed income instruments, and the relative scarcity of local supply of Foreign Exchange to meet foreign investors' demand. Retail investors may be doing some buying of lira at the now-lower price, but Candemir surmised that either the retail demand was not sufficient or that banks were keeping the foreign exchange sold by individuals because banks were bumping up against their regulatory limits on FX open positions. Candemir and Selim Atalay of Dow Jones continued to grumble about the Central Bank's stop-and-go FX buying auctions: Atalay saying the Bank's announcement that it would cease the auctions until May 3 created market uncertainty about what would happen next week.

17. (Sbu) More broadly, several contacts felt that the fall-out from the Cyprus referendum continued to play a role. Even though there was near-unanimity last week among analysts that markets had priced in a yes vote in the north and a no vote in the south, the higher-than-expected no vote in the south may be troubling markets. Central Bank Markets Department official Emrah Eksi echoed some private analysts in saying Turkish markets may have expected too much of a favorable reaction from EU officials to a yes vote in the North, i.e. more praise than has been forthcoming for Turkey's diplomacy.

18. (Sbu) Finally, both Selim Atalay of Dow Jones and Cem Akyurek of Global Securities noted the important role of market manipulation and speculation in the sharp fall in equities. Atalay, claimed that manipulators had run up the stock market over the past two weeks in the hope that foreigners would move in after the North voted yes in the Cyprus referendum, only to have to close their positions when foreign buying failed to materialize.

19. (Sbu) Contacts expect more volatility over the coming weeks and, possibly months, in the absence of a clear anchor for markets. With regard to the Lira, however, there is some hope for renewed appreciation, according to both Candemir and Eski. Both agreed that the summer typically sees strong Foreign Exchange inflows from tourism and from Turks abroad visiting Turkey. Candemir is sticking with his prediction of a stronger lira, though Eksi declined to make a prediction.

110. (Sbu) Finally, most contacts agreed that the volatility was exacerbated by a high degree of herd-like behavior with market participants buying or selling based on other participants' actions.

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